Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1975

No. 75-1222

AARON KRAUT and IRIS KRAUT,
HARRY KRAUT and MARIAN KRAUT,

Petitioners,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION (WITH APPENDICES) FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioners, Aaron and Iris Kraut, and Harry and Marian Kraut, pray that a writ of certiorari be issued to review the final judgment of the United States Court of Appeals for the Second Circuit entered in the office of the clerk on December 31, 1975, as well as the order of that court denying a petition for a rehearing entered in the office of the clerk of that court on January 15, 1976.

Opinions Below

The opinion of the United States Tax Court is reported, 62 T.C. 420 (1974). It is reproduced as Appendix I, *infra*, pp. A1-A26. The opinion of the United States Court of Appeals for the Second Circuit is not yet reported. It is reproduced as Appendix II, *infra*, pp. A27-A40.

Jurisdiction

The Second Circuit rendered its judgment affirming the decisions of the United States Tax Court and entered its order of affirmance on December 31, 1975, and thereafter entered its order denying the petitioners' petition for a rehearing on January 15, 1976 (Appendix III, *infra*, p. A41). The jurisdiction of this Court is invoked under 28 U.S.C. §1254 (1).

Questions Presented

1. In the event of a bona fide sale of stock to a charity, is the excess which the charity pays above that which a non-tax-exempt entity would have paid, entitled to capital gains treatment under *Commissioner* v. *Clay Brown*, 380 U.S. 563 (1965), particularly in the light of the Tax Reform Act of 1969?

2. In the event such excess is taxable as ordinary income, is the Commissioner's arbitrary and unreasonable determination of such excess in a deficiency notice conclusive without more under *Helvering* v. *Taylor*, 293 U.S. 507 (1935)?

3. In the event such excess is taxable as ordinary income, can the Commissioner, consistent with due process, arbitrarily fix the amount of such excess by a presumption without putting in any proof? *Cf. Thompson* v. *City of Louisville*, 362 U.S. 199 (1960); *Garner* v. *Louisiana*, 368 U.S. 157 (1961).

Statutory Provision Involved

Section 1222 (3) of the Internal Revenue Code of 1954

(3) *Long-term capital gain.* The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent that such gain is taken into account in computing gross income.

Statement of the Case

The Commissioner in one of the first applications of his new Rev. Ruling 66-153, 1966-1 C.B. 187, by which he sought to avoid *Commissioner* v. *Clay Brown*, 380 U.S. 563 (1965), in his statutory notices of deficiencies in this case dated October 9, 1970 (9, 14)* acknowledged the validity of the sale by the shareholders of Nassau Corp to the Cathedral of Tomorrow, Inc. (Cathedral), but sought arbitrarily and erroneously to value the stock of Nassau Plastic and Wire Corp (Nassau Corp) at $168,445.60 (31).

On December 16, 1970 the taxpayers Aaron and Iris Kraut and Harry and Marian Kraut, pursuant to 26 U.S.C. §7442, filed their petitions in the Tax Court of the United States for redeterminations of the Commissioner's asserted

* References are to pages of the Joint Appendix.

deficiencies (9, 14). The Tax Court, Judge Arnold Raum presiding, let stand on procedural grounds the Commissioner's arbitrary and erroneous figure of $168,445.60 (286), and on February 21, 1975 entered his decisions of deficiencies for the taxable year 1967 in the amounts of $240,787.08 against Aaron and Iris Kraut (304) and $246,-847.44 against Harry and Marian Kraut (306).

On May 19, 1975 Aaron and Iris Kraut (308) and on May 21, 1975 Harry and Marian Kraut (309), pursuant to 26 U.S.C. §§7482 (a) and (b) (1) (A) and 7483, filed their notices of appeal to the United States Court of Appeals for the Second Circuit.

The taxpayers Iris and Marian Kraut, who owned all of the stock of Nassau Corp, had first contracted to sell their stock to Wilson Mold and Die Corp (Wilson Corp). Nassau Corp and Wilson Corp did not go through with the sale. Subsequently, in a separate three-cornered agreement under date of June 15, 1966, Wilson Corp assigned all of its rights and delegated all of its duties to the Cathedral (195, 280). The Cathedral was an exempt organization; Wilson Corp was not.

The purchase price was not less than $500,000 nor more than $3,500,000 payable out of 75% of Nassau Corp's net income before federal income taxes (280, 166, Ex. 4-D; 195, Ex. 5-E). The assignment from Wilson Corp to the Cathedral resulted from a detailed presentation that Eugene O. Cobert of Management Methods, Inc. made to the Cathedral (121, 199). Management Methods, Inc. was an independent entity that represented the Cathedral. The Cathedral, after a thorough investigation of Nassau Corp, bought the

stock for the same price that Wilson Corp had originally agreed to pay.

Nassau Corp was a new corporation, organized in July, 1965 to develop and manufacture a new product, namely, copper wiring coated with a unique softer plastic insulation to be used in the Christmas tree lighting business (56, 58, 69, 161, Ex. 3-C).

The operations of Nassau Corp were experimental in 1965 but based on the trade's acceptance of its experimental product as evidenced by its year-end order backlog, in 1966 the sales of the new product skyrocketed, for the new product was a dramatically exciting type of Christmas tree lighting wire (69-70). The new softer coated wire had a spectacular market acceptance because it enabled Christmas tree lighting manufacturers to assemble their product with great accuracy and tremendous speed with a minimal rejection rate, as Judge Raum found (277).

In 1967, pursuant to the agreement between the Cathedral and the shareholders of Nassau Corp, the Cathedral paid to the shareholders the amount of $1,268,275. Each of the shareholders after deducting expenses, reported on her 1967 United States income tax return the receipt of the net amount of $606,416.47 as a long-term capital gain pursuant to section 1222 (3) of the Internal Revenue Code of 1954, less those amounts reported as interest income in accordance with section 482 of the Internal Revenue Code of 1954 (138).

Because of the tremendous amount of orders that Nassau Corp had for its Christmas wire in 1966, it projected

earnings over a ten-year period of at least $10-million and regarded this projection as a conservative one (85). Aaron Kraut testified:

> "A. I projected earnings in the area—and this is conservative, over a ten-year period of at least $10,000,000.00.
>
> "Q. If it could produce $10,000,000.00 in earnings over a ten-year period, well, how come you sold it for $3,500,000.00?
>
> "A. Because those were projections, and no one knows what is going to happen six months from now—
>
> "Q. The Cathedral offered you $3,500,000.00 for this business and you sold it immediately?
>
> "A. No.
>
> "Q. Tell me what happened?
>
> "A. We wanted $5,000,000.00 for it.
>
> "Q. Based on what?
>
> "A. On my projected earnings.
>
> "Q. And, why did you accept $3,500,000.00?
>
> "A. Well, it was a matter of bargaining, they didn't want to pay $5,000,000.00, and I didn't want $2,500,000.00 or whatever they come in, I think it was $2,500,000.00" (85-86).

Nassau Corp's earnings over a 3-year period from July 1, 1965 through June 30, 1968 were more than $2-million (Exs. 1-A, 2-B). Thus, Nassau Corp's average yearly net profit was $666,000.

In 1966 and 1967 the Cathedral paid the shareholders of Nassau Corp the sum of $1,480,750 (137-39, 149, Exs. 1-A, 2-B). This represented but 75% of the net income before Federal income taxes. At this rate the Cathedral

would have paid out the shareholders of Nassau Corp in another two years in accordance with the terms of the agreement of sale (195, Ex. 5-E).

The sale of Nassau Corp's stock to the Cathedral for $3½-million was the result of hard bargaining at arm's length. Although the Cathedral was a charity, the record indicates that it exercised careful and considered business judgment in negotiating this purchase.

Nevertheless, the Commissioner in his statutory notice arbitrarily picked the figure of $168,445.30, out of a hat as it were, a figure which is less than 5% of the actual price the parties themselves arrived at, and hardly more than 10% of the amount that the Cathedral actually paid to the shareholders of Nassau Corp in 1967. Yet the Commissioner, throughout these proceedings, conceded the bona fides of the sale to the Cathedral. It is as if the Commissioner's left hand did not know what his right hand was doing. One thing is clear and that is that his picking of the figure of $168,445.30 is arbitrary governmental action at its worst.

At trial, Judge Raum did not follow the apportionment rule which the Second Circuit announced in 1974, reversing on this point the Tax Court, in *Berenson* v. *Commissioner*, 507 F.2d 262 (2d Cir. 1974), *aff'g in part, rev'g in part, and remanding* 59 T.C. 412 (1972). The instant case was tried in 1973 in between these two rulings. Judge Raum, following *Berenson* in the Tax Court, felt that the purchase price in *Kraut* so substantially exceeded the statement net worth of Nassau Corp that the transaction did not constitute a sale. In the Second Circuit the petitioners argued that

Judge Raum failed to take into account the inherent value of Nassau Corp's business, which had a potential for making millions in profits and did make more than $2,000,000.00 in a short period of time. The parties to the transaction, namely, the petitioners and the Cathedral did take into account the inherent value of Nassau Corp's business.

On the point of valuation, the Second Circuit reversed the Tax Court in *Berenson* and established an apportionment rule which required a determination of the excess that a charity paid over what a non-tax-exempt entity would have paid. Judge Raum deciding *Kraut* before the Second Circuit reversed in *Berenson* did not get into the question of the excess a charity pays over what a non-tax-exempt entity would have paid. Neither did the petitioners. Judge Raum thus reached the result of holding on the one hand that there was no sale and on the other hand that the Commissioner was procedurally bound by his statutory notice. In this way, Judge Raum let stand the Commissioner's arbitrary and unsupported figure of $168,445.30.

The Second Circuit rejected Judge Raum's view that there was no sale, but nevertheless let his decision stand on the ground that since the Commissioner's statutory notice had contained some apportionment, the petitioners in their turn were now procedurally barred on appeal from attacking it because they failed to overcome the presumption of correctness in the Commissioner's determination.

Thus, the petitioners were effectively denied a meaningful evidentiary hearing on the value of the stock of Nassau Corp; for neither the petitioners nor Judge Raum knew about the Second Circuit's apportionment test in *Berenson,*

which came in November 1974, nearly a year after the trial of the instant case before Judge Raum. As a result, the petitioners made no effort in the Tax Court to show what a non-tax-exempt entity would have paid for the stock of Nassau Corp, the critical element in the Second Circuit's apportionment test. Indeed, if the petitioners had sought to introduce such evidence, Judge Raum might well have excluded it on the ground that he did not consider it relevant.

Reasons for Granting the Writ

I

The transaction between the shareholders of Nassau Corp and the Cathedral was a bona fide sale for a fair price that falls squarely within *Commissioner* v. *Clay Brown,* 380 U.S. 563 (1965), but the Second Circuit held exactly to the contrary.

The Second Circuit was "constrained to find that the sale was bona fide under *Clay Brown*" (App. II at p. A34); yet reached just the opposite result. Indeed, the Commissioner treated the transaction between the Cathedral and the shareholders of Nassau Corp as a valid sale of stock in his statutory notice; and further acknowledged its bona fides in his brief and argument in the Second Circuit.

In doing so, the Commissioner paid lip service to *United States* v. *Clay Brown,* 380 U.S. 563 (1965), where he had earlier contended that since the charity assumed no independent liability for the purchase price, there was no sale. To this contention the Supreme Court responded:

"to say there is no sale because there is no risk-shifting and that there is no risk-shifting because the price to be paid is payable only from the income produced by the business sold, is very little different from saying that because business earnings are usually taxable as ordinary income, they are subject to the same tax when paid over as the purchase price of property. This argument has rationality but it places an unwarranted construction on the term 'sale', is contrary to the policy of the capital gains provisions of the Internal Revenue Code, and has no support in the cases. We reject it." At 570.

Justice Harlan in his concurring opinion added:

"Obviously the Institute traded on its tax exemption. The Government would deny that there was an exchange essentially on the theory that the Institute did not put anything at risk; since its exemption is unlimited, like the magic purse that always contains another penny, the Institute gave up nothing by trading on it.

"One may observe preliminarily that the Government's remedy for the so-called 'bootstrap' sale—defining sale or exchange so as to require the shifting of some business risks—would accomplish little by way of closing off such sales in the future. It would be neither difficult nor burdensome for future users of the bootstrap technique to arrange for some shift of risks. If such sales are considered a serious abuse, ineffective judicial correctives will only postpone the day when Congress is moved to deal with the problem comprehensively. Furthermore, one may ask why, if the Government does not like the tax consequences of such sales, the proper course is not to attack the exemption rather than to deny the existence of a 'real' sale or exchange." At 580.

The Commissioner tried to get the law changed legislatively but the Congress did not respond favorably until 1969. When the Congress did respond, it did not deprive the seller of capital gains treatment.

The Commissioner tried to get the law changed in 1963 to deprive seller of capital gains treatment. The Congress did not act. From this failure to act in 1963, the Court in *Clay Brown* inferred that sellers were to continue to get capital gains treatment. Today this is no longer a matter of inference; for when Congress did act in 1969 it still did not deprive sellers of capital gains treatment.

In short, the Second Circuit's apportionment rule is wrong, the Commissioner's Rev. Ruling 66-153, 1966-1 C.B. 187 is wrong, and the Second Circuit's decision in *Berenson* is wrong.

In the *President's 1963 Tax Message* we find:

"Pursuant to the President's recommendation that changes be effected in the definitional aspect of capital gains taxation, it is proposed that payments on the sale of a capital asset (or payments so treated under present law) which are deferred over more than 5 years and are contingent on future income be treated as ordinary income."

Hearings before the House Committee on Ways and Means, 88th Cong., 1st Sess., Feb. 6, 7, 8 and 18, 1963, Pt. 1 (rev.), on the President's 1963 Tax Message, p. 154.

With reference to the Commissioner's 1963 attempt, the Court in *Clay Brown* wrote:

"There is another reason for us not to disturb the ruling of the Tax Court and the Court of Appeals.

In 1963, the Treasury Department, in the course of hearings before the Congress, noted the availability of capital gains treatment on the sale of capital assets even though the seller retained an interest in the income produced by the assets. The Department proposed a change in the law which would have taxed as ordinary income the payments on the sale of a capital asset which were deferred over more than five years and were contingent on future income. Payments, though contingent on income, required to be made within five years would not have lost capital gains status nor would payments not contingent on income even though accompanied by payments which were. Hearings before the House Committee on Ways and Means, 88th Cong., 1st Sess., Feb. 6, 7, 8 and 18, 1963, Pt. 1 (rev.), on the President's 1963 Tax Message, pp. 154-156.

"Congress did not adopt the suggested change but it is significant for our purposes that the proposed amendment did not deny the fact or occurrence of a sale but would have taxed as ordinary income those income-contingent payments deferred for more than five years. If a purchaser could pay the purchase price out of earnings within five years, the seller would have capital gain rather than ordinary income. The approach was consistent with allowing appreciated values to be treated as capital gain but with appropriate safeguards against reserving additional rights to future income. In comparison, the Commissioner's position here is a clear case of 'overkill' if aimed at preventing the involvement of tax-exempt entities in the purchase and operation of business enterprises. There are more precise approaches to this problem as well as to the question of the possibly excessive price paid by the charity or foundation. And if the Commissioner's approach is intended as a limitation upon the tax treatment of sales generally, it represents a

considerable invasion of current capital gains policy, a matter which we think is the business of Congress, not ours.

"The problems involved in the purchase of a going business by a tax-exempt organization have been considered and dealt with by the Congress. Likewise, it has given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations it has responded, if at all, with precise provisions of narrow application. We consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications.' *American Automobile Assn.* v. *United States,* 367 U.S. 687, 697." At 578-79.

In 1969 the Commissioner was more successful in obtaining new legislation. But the instant case involved the year 1967.

One will further note that in all of the Treasury Department position papers from 1963 to 1969 for new tax legislation it never challenged the validity of such a sale as that involved in the instant ase. Rather, it sought in one way or another to have earnings taxed as ordinary income rather than as capital gains.

The Treasury Department in its study of 428 pages in 1969 for the House Ways and Means Committee began its treatment of sales such as the one in the instant case with these paragraphs:

> "H. H. 12663 and H. R. 12664 were introduced in the 90th Congress. They are designated to deal with the problems raised when tax exempt organizations borrow money for purposes unrelated to their func-

tions. These problems were emphasized by the 1965 decision of the Supreme Court in *Commissioner* v. *Clay B. Brown,* 380 U.S. 563. In the *Clay Brown* case, the Supreme Court approved capital gains treatment for persons who sold a sawmill and lumber business to a tax-exempt organization in an arrangement elaborately structured both to avoid payment of Federal income tax upon the earnings of the business and to immunize the exempt organization from any liability or risk of loss. By means of the arrangement, the exempt organization undertook to acquire ownership of the business—valued at $1,300,000—entirely without investment of its own funds.

"The availability of the tax exemption for uses in transactions following this pattern creates several serious problems. First, when the purchase price of a business or other income-producing property is to be financed from the future earnings of the property, tax-exempt organizations are uniquely suited to pay a considerably higher price than other purchasers can afford; their exemption makes it possible for them, in effect, to pay to the former owners of the business the money which a taxable purchaser would have to pay to the Government in taxes. This advantage of exempt organizations creates a strong incentive for the sale of businesses to them. Secondly, the price inflation characteristic of transactions of this type diverts to the personal advantage of private parties a substantial measure of the benefit which Congress intended tax exemption to produce for the organizations on which it conferred the exemption. Dealing with a closely related problem some years ago, both the House Ways and Means Committee and the Senate Finance Committee referred to this result as a 'sale of the exemption.' "

Hearings before the House Committee on Ways and Means, 91st Cong., 1st Sess., Apr. 22, 1969, Pt. 14, pp. 5050, 5358-

59. However, nowhere did the Treasury challenge the validity of sales to exempt organizations.

The legislative solution to *Clay Brown* was to deprive tax-exempt organizations of the commercial advantage flowing from their tax-exempt status to the extent they acquire businesses on credit (with the obligation typically limited to the assets acquired or earnings therefrom). The general nature of the new provisions was briefly described in the Senate Report (at pp. 63-64) as follows:

> "Explanation of provision. Both the House bill and the committee amendments provide that all exempt organizations' income from 'debt-financed' property, which is unrelated to their exempt function, is to be subject to tax in the proportion in which the property is financed by the debt. Thus, for example, if a business or investment property is acquired subject to an 80 per cent mortgage, 80 per cent of the income and 80 per cent of the deductions are to be taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes."

The significant lesson to be learned from the congressional action taken as a result of *Clay Brown* and its impact on the decisions now sought to be reviewed, is that Congress did not deprive the seller of its right to receive capital gain treatment of the proceeds of the sale of an unrelated business to a tax-exempt organization. Instead, it deprived the tax-exempt entity of some of its tax exemption where the acquisition was debt-financed. There can be no doubt that this amendment to the Internal Revenue Code was perceived and intended as the proper response to the *Clay Brown* problem. Indeed it was referred to as the "*Clay*

Brown provision" (Senate Report, pp. 62-63; Senate Hearings, p. 37).

The principal spokesman for the Treasury at the 1969 hearings was the Honorable Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy. In his testimony before the Ways and Means Committee (at p. 5491), Mr. Cohen referred to the Treasury recommendation as follows:

> "We also recommend extending the provisions for taxation of unrelated business income to churches and other exempt organizations not now subject to these provisions. We recommend enacting legislation to overcome the effect of the Supreme Court decision in the *Clay Brown* case, a bill which has previously been introduced and is pending before the committee."

This was amplified in his written statement (at p. 5509):

> "8. Enact pending legislation to overcome the effect of the Supreme Court decision in the *Clay Brown* case to prevent a charitable organization from borrowing to purchase investment assets. The effect of such borrowing is often to pass the benefit of the tax exemption on to the seller, a non-exempt party, in the form of an artificially high price. There is no warrant in any event for a tax-exempt organization borrowing money to purchase income producing assets unrelated to its charitable function."

In the hearings before the Senate Finance Committee (at page 567) Mr. Cohen presented a statement which explained the proposed amendment as one which "prevents a tax-exempt organization from extending its tax shelter to a non-exempt seller through inflation of the price." It is clear that the legislation ultimately adopted by the Con-

gress showed an election to solve *Clay Brown* by acting upon the tax exemption rather than disturbing the capital gain treatment which *Clay Brown* mandated. Indeed the Second Circuit so held in *Berenson* v. *Commissioner,* 507 F. 2d 262, 267 (2d Cir. 1974), when it wrote:

> "To recount the Commissioner's victory in Congress, the Tax Reform Act of 1969 stripped transactions, such as that recognized to be a 'sale' in *Clay Brown,* of their tax avoidance potential by ensuring that the income from the business in the hands of the exempt organization was taxable as unrelated business income. Section 511 (a) (2) (A) was amended to subject churches and related organizations to the tax imposed by §511 (a) (1) upon 'unrelated business taxable income'; §514 was also revamped to ensure that rental income from all leases of business assets acquired through debt financing would be included within the exempt organizations' 'unrelated business taxable income.' No effort was made to alter the §1222 (3) capital gains provision at issue both here and in *Clay Brown.* Consequently, congressional disapproval of the Supreme Court's resolution of the 'sale' issue in *Clay Brown* cannot be inferred."

The Second Circuit has taken a curiously myopic approach to *Clay Brown* cases. It has acknowledged, as it must, the binding authority of *Clay Brown,* but then has proceeded to a result which is just to the contrary. It has found the sale involved to be bona fide, but then has refused to give the proceeds of the sale capital gains treatment.

Judge Raum, following *Berenson* v. *Commissioner,* 59 T.C. 412 (1972), *aff'd in part, rev'd in part, and remanded,* 507 F. 2d (2d Cir. 1974), in the Taxt Court on the point on which the Second Circuit reversed and remanded for an evidentiary hearing, in effect held that because the

Cathedral, in his mind, agreed to pay more than a non-tax-exempt entity would have paid, there was no sale. The Second Circuit affirmed, but contrary to what it did in *Berenson* did not reverse in part and remand for an evidentiary hearing on value. Thus, the taxpayers never had a meaningful day in court on the value of the stock of Nassau Corp.

II

Where a question of valuation is involved and the Commissioner's determination of a deficiency is arbitrary, unreasonable and unsupported by any evidence, the taxpayers, at the very least, are entitled to an evidentiary hearing on the question of value.

The taxpayers introduced evidence to show that the fair market value of the stock of Nassau Corp in 1967 was $3,500,000. The Commissioner introduced no evidence at all on fair market value, not even a scintilla.

Revenue Agent Meyer Shapiro, who had been an Internal Revenue agent for more than 25 years (34), treated the transaction between the Cathedral and the shareholders of Nassau Corp as a valid sale and valued the stock at $500,000 (39; Ex. 7; Sched. 4-A2; Ex. 8, Sched. 4-A2). In Schedule 4-A2 of Exhibit 7, Mr. Shapiro wrote:

	1966	*1967*	*Total*
Deemed Sale Price of Capital Asset	$69,331.25	$180,668.75	$250,000.00
Basis of Cost	100.		100.
Capital gain realized at 100%	69,231.25	180,668.75	249,900.00

In Schedule 4-A2 of Exhibit 8, he wrote:

	1966	*1967*	*Total*
Deemed Proceeds of Sale of Capital Asset	$69,331.25	$180,668.75	$250,000.00
Cost Basis allowed	100.		100.
Capital gain realized —100%	69,231.25	180,668.75	249,900.00

The Commissioner himself assigned to the stock the value of $168,445.60 (31), but there is no sure way of determining just how he arrived at this figure. Here we have two members of the same agency, one of whom values the stock at $500,000, and the other, the Commissioner, at one-third of that amount, $168,445.60; dramatic proof, the petitioners submit, that the $168,445.60 figure is arbitrary and unreasonable.

The taxpayers concede that the Commissioner's determination of a deficiency is presumptively correct. This is as it should be, for the facts with reference to income and deductions are peculiarly within the knowledge of the taxpayer. See the discussion in 1 *Weinstein's Evidence* 300-1 to 300-16 (1975).

However, if the facts are not peculiarly within the knowledge of the taxpayer, where, for instance, as here, a question of valuation is involved and the facts are as much within the knowledge of the Commissioner as of the taxpayer, the taxpayer's burden should be no greater than that of showing that the Commissioner's determination is arbitrary and unreasonable. This Court so held in *Helvering* v.

Taylor, 293 U.S. 507 (1935). That case involved an apportionment of costs between preferred and common stock. The Court held:

> "Unquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid. *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 271. *Wickwire* v. *Reinecke*, 275 U.S. 101, 105. *Welch* v. *Helvering*, 290 U.S. 111, 115. Frequently, if not quite generally, evidence adequate to overthrow the commissioner's finding is also sufficient to show the correct amount, if any, that is due. See, e.g., *Darcy* v. *Commissioner*, 66 F. (2d) 581, 185. But, where as in this case the taxpayer's evidence shows the commissioner's determination to be arbitrary and excessive it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him." At 515.

In *Clay Brown* itself, the Court indicated that if the Commissioner contends that the price which a charity pays is excessive because of the lack of risk-shifting, he has to come forward with proof; for in that case the Court said: "Secondly, if an excessive price is such an inevitable result of the lack of risk-shifting, it would seem that it would not be an impossible task for the Commissioner to demonstrate the fact." 380 U.S. at 573. In the instant case, as we have said, the Commissioner introduced no evidence at all of fair market value.

Reference may also be made to *Commissioner* v. *Riss*, 374 F. 2d 161 (8th Cir. 167); *Stout* v. *Commissioner*, 273 F. 2d 345 (4th Cir. 1959); *Andrews* v. *Commissioner*, 135 F.

2d 314 (2d Cir.), *cert. denied*, 320 U.S. 748 (1943). In *Stout* v. *Commissioner*, *supra*, the Fourth Circuit wrote:

> "The presumption of correctness is procedural. It transfers to the taxpayer the burden of going forward with evidence, but it disappears in a proceeding to review the assessment when substantial evidence contrary to the Commissioner's finding is introduced. Thereafter, the Tax Court, in such a proceeding, must make its own findings based upon the evidence before it, and we may affirm only if the findings of the Tax Court are supported by substantial evidence in the record of that proceeding." At 350.

In their brief and reply brief the petitioners asked the Second Circuit to reverse the decisions of the United States Tax Court and annul the deficiency. In their petition for rehearing the petitioners beseeched the Second Circuit to reverse in part and remand for an evidentiary hearing as to the value of the stock of Nassau Corp to a non-tax-exempt entity for the purpose of applying the Second Circuit's apportionment rule. The taxpayers at the time of their trial in the Tax Court in November 1973 of course did not know about the Second Circuit's apportionment rule announced in *Berenson* in 1974, almost a year later.

Nevertheless, the Second Circuit gave the taxpayers no chance to have such an evidentiary hearing. Instead, the court simply stated: "The burden of establishing what was a fair market value therefore remained with the taxpayer." App. II at p. A35. The result is that the taxpayers were deprived of any meaningful evidentiary hearing on the fair market value of the stock of Nassau Corp.

The Commissioner's figure of $168,445.30 is not only arbitrary, but also manifestly incorrect under the Second

Circuit's apportionment rule in *Berenson*. The Second Circuit said:

> "* * * The same tax exemption which gives an unfair competitive advantage to an exempt organization in the operation of a business also permits it an unfair degree of purchasing power in the acquisition of such a business. We think it would be inappropriate to include an increase in value, attributable solely to the presence of such unfair purchasing power, within the past accrued appreciation that the capital gains provisions seek to shield from taxation at ordinary rates. * * *
>
> * * *
>
> "* * * It will be necessary for the Tax Court, as a beginning computation, to separate the purchase price into the portion that is attributable to the accumulated value of the corporations at the time of the purchase and the portion attributable solely to the extra purchasing power possessed by Temple by virtue of its tax-exempt status." At p. 266.

In no case can "the portion attributable solely to the extra purchasing power" possessed by the charity because it was tax-exempt exceed the amount of the taxes that it did not have to pay, in the instant case, 48%. Therefore the Commissioner's figure of $168,445.30, which is but 5% of the purchase price that the parties arrived at themselves by hard bargaining in an unchallenged arm's length transaction (and hardly more than 10% of the money that the Cathedral actually paid to the petitioners) is clearly erroneous.

Even if the petitioners failed in the burden of proof to show what a non-tax-exempt entity would have paid they are at least entitled to a new hearing under *Helvering* v. *Taylor*, 293 U.S. 507 (1935), because the Commissioner's statutory notice is not only arbitrary but also clearly erroneous.

In reducing the Commissioner's position to its logical absurdity. the petitioners observe that had they sold to a non-tax-exempt entity under the same no-risk terms except that the purchase price was payable out of after-tax instead of pre-tax profits, they would have received in excess of $700,000.00, unchallenged by the Commissioner as being entitled to capital gains treatment, for an asset the Commissioner would have us believe is not worth more than $168,445.30.

The sources for the Commissioner's valuation, in the absence of any evidence, can only be a matter for speculation; but the petitioners respectfully submit that the consequence of his error is categorically mandated by the Court's decision in *Helvering* v. *Taylor*, 293 U.S. 507 (1935): at the very least the petitioners are entitled to a meaningful evidentiary hearing.

III

The Commissioner cannot, consistent with due process, arbitrarily fix the amount of a valuation by a presumption without putting in any proof.

It is contrary to due process in a contested case for the government to prevail without putting in a single particle of proof. *Cf. Thompson* v. *City of Louisville*, 362 U.S. 199 (1960); *Garner* v. *Louisiana*, 368 U.S. 157 (1961). It is also relevant to add that such a course is unbecoming a free people.

Presumptions of correctness are intended, as a matter of public policy, to put the burden of proof on the party

who has superior means of proof. As to most items in a taxable transaction, such as income and expenses, we concede that this is the taxpayer. But where the Commissioner challenges the consequences of a transaction as proved, and valuation is an issue, then, as in the case of an affirmative defense, the Commissioner should have the burden of proof; or, minimally at least, the duty to substantiate by evidentiary offering equal to that necessary to establish a prima facie case, his contended for evaluation. In this circumstance, due process forbids a presumption of correctness in such an item as valuation in the Commissioner's statutory notice.

Conclusion

The Court should grant this petition for a writ of certiorari and rule once again as it did in *Clay Brown* that a sale to a tax-exempt charity remains a sale even though the charity assumes no independent liability for the purchase price.

Respectfully submitted,

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APPENDIX I

Opinion of Judge Raum

62 T. C. 420 (1974)

UNITED STATES TAX COURT

AARON KRAUT AND IRIS KRAUT, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

HARRY KRAUT AND MARIAN KRAUT, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 7663-70, 7664-70. Filed June 27, 1974.

In 1965 petitioners organized and became the sole stockholders of Nassau Plastic & Wire Corp. ("Nassau") to manufacture wire to be used in Christmas decorations. Less than one year later, petitioners entered into an agreement to sell their Nassau stock to Cathedral of Tomorrow, a Federally tax-exempt religious organization, which simultaneously agreed to liquidate Nassau. Nassau's assets consisted almost entirely of a second hand automobile, $50,000 of receivables, and a five-year lease of its single piece of machinery—all subject to liabilities in excess of $36,000. The stated sales price was a flexible amount ranging from a minimum of $500,000 to a maximum of $3,500,000, and was payable primarily out of 75 percent of the business' net income for the ensuing ten years. As employees, petitioners remained in control of the operation of the business. In the event of default, petitioners' sole recourse was the enforcement of a lien upon the business' assets. The lease agreement for the machine entitled the lessor, a corporation wholly-owned by petitioners, to terminate the lease unilaterally after the expiration of its initial term. *Held,* this transaction amounted merely to the payment of a fee to Cathedral in return for lending its tax exemption to Nassau's earnings rather than the actual transfer of the business to Cathedral, and it therefore did not constitute a bona fide sale of a capital asset within the meaning of section 1222(3).

Sidney N. Solomon, Fredric Scheinfeld, and *O. John Rogge,* for the petitioners.

Stanley J. Goldberg and *Walter C. Welsh,* for the respondent.

The Commissioner determined deficiencies in petitioners' 1967 income tax as follows:

Docket No.	*Petitioners*	*Amount*
7663-70	Aaron and Iris Kraut	$254,437.12
7664-70	Harry and Marian Kraut	258,544.82

The cases were consolidated for trial. At issue is whether an agreement by which two of petitioners purported to transfer the stock of their wholly-owned corporation to a tax-exempt charitable organization in exchange primarily for a portion of the business' profits for a period of ten years constituted a bona fide sale within the meaning of section 1222(3), I.R.C. 1954, thereby entitling petitioners to capital gains treatment in respect of the proceeds. In the event such a sale did occur, there is the further question whether those proceeds in excess of approximately $168,000 were capital gains.

Finding of Fact

The parties have filed a stipulation of facts, which, together with its accompanying exhibits, is incorporated herein by this reference.

Petitioners Iris Kraut and her husband Aaron Kraut resided in Oceanside, New York, at the time they filed their petition herein; petitioners Marian Kraut and her husband Harry Kraut resided in Flushing, New York, at

the time they filed their petition herein. Both pairs of petitioners timely filed joint Federal income tax returns for the year 1967 with the district director of internal revenue at Brooklyn, New York.

Aaron Kraut and his brother Harry together were in the business of developing and manufacturing electric wire of various types. For at least 20 years they had owned and acted as president and vice president, respectively, of Trio Wire & Cable Corporation ("Trio"), which was primarily concerned with the production of assorted types of wires and cables encased in plastic insulation. In addition to and as an offshoot of that business the Kraut brothers in or around 1960 formed a separate corporation, Christmas Wire Manufacturing Corporation ("Christmas Wire"), through which they hoped to penetrate the more specialized and very competitive market for wiring used in the manufacture of Christmas decorations. Although Trio itself did not produce such wire, it owned the necessary machine, an extruder, which Christmas Wire made use of. The extruder was housed in a leased building, one of three separate but interconnected buildings on Meserole Avenue in Brooklyn in which Trio carried on its business. That machine appears to have been the only item of equipment used in the production of the Christmas wire, and the record fails to show that any appreciable number of employees was engaged in its operation.

The heart of the manufacturing process for Christmas wire consisted of extruding a coat of plastic insulation around light gage wire. The Christmas decoration manufacturers who purchased the wire then attached light bulb

sockets to it by means of small brass spurs on the sockets which punctured the plastic jacket and made contact with the electric wire inside. A major problem for manufacturers of such wire was the normally tough consistency of the plastic used which created difficulty in attaching the sockets and thus led to a high "rejection rate" in the decoration assembly process. As a result of various problems, primarily the rejection rate, the Kraut brothers brought production under Christmas Wire's name to an end sometime in the spring of 1965. Although the Krauts "sold" the Christmas Wire corporation at that time at a price not satisfactorily shown in the record, the purchaser never conducted operations at the Meserole Avenue location. The Krauts retained the use of Christmas Wire's premises as well as Trio's extruder which remained there. Within a very short time thereafter, possibly as little as several weeks and certainly no more than a few months, Harry and Aaron Kraut formed another corporation, Nassau Plastic & Wire Corporation ("Nassau"), which they intended would operate as an adjunct to Trio similar in fashion to Christmas Wire. As a matter of convenience, Nassau issued all of its stock, 200 shares, in equal amounts to Iris and Marian Kraut in return for their contributions to its capital of $100 apiece. Although neither Aaron nor Harry contributed to Nassau's capital, they nonetheless were the dominant figures in its activities, while their wives provided no services at all to it. Nassau occupied the same premises which Christmas Wire had previously used, and its only equipment was the extruder belonging to Trio which Trio had in the past supplied to Christmas Wire.

Nassau required the extruder to manufacture Christmas wire with a new insulating material which, due to its easily penetrable consistency, promised to minimize the rejection problem associated with conventional plastic insulation. This new material was, however, "an unknown quantity", and its resistance to wear and decay over a period of several years was as yet unproven. Despite the new material's alleged superiority to the insulating material commonly in use at the time, the Krauts did not obtain, nor apparently did they apply for, a patent on it.

On its Federal income tax return for the fiscal year ended June 30, 1966, Nassau reported gross income of $26,189.84, which represented the difference between its sales of $492,305.16 and its cost of goods sold, $466,115.32. The cost of goods sold consisted entirely of merchandise bought for manufacture or sale; Nassau reported no expense for salaries and wages other than $2,600 paid to the Krauts, no expense for use of the extruder, nor any expense for the building in which it was kept. As of June 30, 1966, Nassau maintained no inventory whatsoever. After deducting the Krauts' salaries, taxes, depreciation on a car, and $5,913.40 of operating expenses, Nassau reported a taxable income of $15,831.56 and a resultant tax liability of $3,482.94.

At some time in the early part of 1966, Management Methods, an investment counseling and legal firm located in New York City, brought to Reverend Rex T. Humbard, its client, a proposal for the purchase of Nassau. Reverend Humbard was the pastor of the Cathedral of Tomorrow ("Cathedral"), a Federally tax-exempt religious organiza-

tion in Akron, Ohio. Its activities included conducting Sunday services, a Sunday school, and youth groups as well as sponsoring the worldwide telecast of its church services and supporting an extensive missionary program. Among its assets, Cathedral owned two businesses, at least one of which it had acquired in an entirely debt-financed transaction. After expressing his preliminary interest in the proposal concerning Nassau, Reverend Humbard with his associates undertook to examine Nassau's business more closely.

Before the parties had entered a binding agreement, however, Iris and Marian Kraut executed an agreement with a party identified only as Wilson Mold & Die Corporation ("Wilson") on May 31, 1966, purporting to sell to it their entire interest in Nassau, payments to commence on September 1, 1966. Beyond its participation in this contract, the record contains no evidence as to any and all particulars in respect of Wilson and its principals.

On the following day, June 1, 1966, Trio and Nassau executed an agreement whereby Trio leased to Nassau the extruder which Nassau had theretofore been using along with its accompanying apparatus. The lease was to run for a term of five years, to continue indefinitely thereafter but subject to termination by either party upon 60 days' written notice. Nassau agreed to pay Trio $500 per month. The lease further provided that:

> The Lessor [Trio] shall at all times have free access to the machines for the purpose of inspection or observation, or to make alterations, repairs, improvements,

> or additions, or to determine the nature or extent of use of the machines.

Furthermore:

> The machines shall be used only by operators in the direct employ of the Lessee [Nassau], and only in the factory now occupied by it at its principal place of business, and shall be used only for the purpose of insulating and spooling copper wire, made by or for the Lessee.

Iris and Marian Kraut signed on behalf of Nassau.

Shortly thereafter, before the time of its performance had arrived, Nassau and Wilson abandoned their purported contract of sale. In a separate three-cornered agreement dated June 15, 1966, only 15 days after the initial contract, Wilson assigned all of its rights and delegated all of its duties arising under the May 31, 1966, agreement to Cathedral; Iris and Marian Kraut agreed to release Wilson from the prior contract; and Cathedral covenanted to purchase Nassau's stock according to the following terms:

> The Buyer [Cathedral] shall take all such action as may be required so that on or as of June 25, 1966 Nassau Plastic shall be liquidated and all of its assets distributed to the Buyer. Simultaneously with the execution of this Agreement, the Buyer, with the consent of the stockholders and directors of the Sellers [Iris and Marian Kraut], shall take steps forthwith to accomplish the following:
>
> (a) Create a separate operating-manufacturing unit, owned by the Buyer, to be denominated and known as Nassau Plastic (hereinafter sometimes in-

terchangeably referred to as "Nassau Plastic & Wire Co." * * *); the Buyer to file such documents with the proper governmental authorities as may be necessary to effectuate the same.

(b) The name of Nassau Plastic & Wire Corp. shall be changed forthwith, to such name as the Buyer may designate.

* * *

The purchase price for all of the stock sold under this Agreement shall be not less than $500,000 (hereinafter called the "Minimum Price") nor more than $3½ million (hereinafter called the "Maximum Price"). The purchase price shall be paid by the Purchaser to the Sellers at the following time in the following manner and to the extent set forth below:

(a) For the period from June 25, 1966 to July 1, 1966, 100% of the net income of the Corporation shall belong to the Sellers; the Purchasers shall receive credit for said amount toward the purchase price.

(b) $50,000 on or before August 1, 1966.

(c) For the balance of the year 1966 and in each of the years 1967 through 1976 terminating however on June 30, 1976 inclusive, unless the Maximum Price be paid in full prior thereto; commencing with the 15th day of October 1966 and on the 15th day of each January, April, July and October thereafter in respect to each preceding quarterly period from July 1, 1966 through June 30, 1976, an amount equal to 75% of the Corporations [sic] net income before Federal income taxes for each of such next preceding fiscal periods. In the event a loss occurs in any quarterly period, said loss shall be utilized as an offset in each of the succeeding quarterly periods (until said loss has been recouped) before payments to the Sellers are resumed.

(d) In any event and notwithstanding any provision in this Agreement with respect to the contingent deferral of installment payments of the Purchase Price, the full Minimum Price referred to above and any portion of the Maximum Price referred to above which Sellers may become entitled to receive shall be paid in full on or before July 15, 1976.

(e) The Purchaser may prepay at any time all or any part of the unpaid amount of the Maximum Price.

The terms of payment agreed to by Cathedral largely reflected the substance of Wilson's antecedent commitment, the one notable difference being that Wilson had agreed to pay 75 percent of its pre-tax earnings only through June 30, 1971, thereafter applying the same percentage to its after-tax income for the duration of the ten-year period.

The ultimate transaction did not contemplate any cash outlay by Cathedral, either at the outset or in the event of default. Although the terms of the contract provided for an initial $50,000 payment on August 1 irrespective of Nassau's profits, Nassau's assets at the time of the purported sale included $50,089.75 of notes and accounts receivable plus $2,323.36 in cash. In point of fact, petitioners permitted Cathedral to postpone that payment until mid-October, 1966, by which time Nassau had generated sufficient cash flow from which Cathedral could pay petitioners. Even though Iris and Marian Kraut retained a security interest in all of the assets, business, and good will of Nassau, their interest was subject not only to prior liens, but to "the rights of present and future general creditors for obliga-

tions arising in the regular course of business, and liens, collateral or security for the loan or loans advanced or to be advanced by any bank." Moreover, it was stipulated that, in the event of Cathedral's default in payments or otherwise, enforcement of the security agreement would constitute the seller's exclusive remedy "and in no event shall the Sellers seek any deficiency judgment or other judgment for damages against the Buyer." In addition thereto, Cathedral agreed to employ both Harry and Aaron Kraut as its chief executive officers, Aaron in the capacity of production manager and internal office manager and Harry as sales manager. As such, Cathedral granted them full authority and responsibility to direct the business of Nassau in every respect. For such services, Cathedral agreed to pay them each $5,200 yearly, their employment to terminate on the day following the date of Cathedral's final payment to Iris and Marian.

At the time of this agreement, Nassau owned neither the building in which it operated nor the single piece of machinery with which it produced wire. Its interest in the machine consisted of the five year lease from Trio described above. On its tax returns for the year ending June 30, 1966, it listed total assets in the amount of $53,867.56, of which notes and accounts receivable amounted to $50,089.75; the remaining assets consisted of cash and an automobile. In the same return, it reported $36,575.99 in accounts payable while its capital account showed $200 in respect of its common stock.

Following the disposition of the stock, Nassau's operations continued at the same location with the same personnel using the same equipment, and apparently under the same or a very similar name. Harry and Aaron Kraut, as "Cathedral's employees", still managed the business. Under this arrangement the business met with early and quite remarkable success. Although on August 1 the business' cash flow apparently had been insufficient to provide Cathedral with the funds necessary to make the down payment then due, on October 12 Harry Kraut drew two checks of $25,000 each on Nassau's account in favor of Cathedral which Reverend Humbard then endorsed as payable to Iris and Marian Kraut individually. During the remainder of 1966 Cathedral paid Iris and Marian an additional $97,500; in 1967 Cathedral paid them a total of $1,332,500,[1] which raised the overall level of payments to $1,480,000. After 1967, though, the business rapidly became unprofitable, and in 1969 it ceased operating altogether. The sudden turnabout in the business' fortunes was attributable, at least in part, to its competitors' ability to reduce the rejection rate of their Christmas wire through improved techniques and production quality. Ownership of Nassau's then remaining assets, which were of negligible value, reverted to the original owners.

In each of their respective joint income tax returns for 1967, petitioners reported the receipt of $66,250 from Cathedral, of which they treated $27,720.83 as interest and from which they deducted collection expenses of $32,112.50, primarily brokers' commissions. They then listed the net amount of $606,416.67 in each return as long-term capital

1. This is a gross amount against which there should be charged $64,225, the related expenses of collection, leaving a net amount of $1,268,275.

gains and computed their tax liability according to the alternative tax provided in section 1201(b). In each of his deficiency notices, the Commissioner determined

> that $595,766.09 of the amount collected in 1967 pursuant to the sale of your shares of stock in Nassau Plastics & Wire Corp. to the Cathedral of Tomorrow, Inc. in 1966, payments to be made out of the profits of the company sold, constitutes ordinary income to you in 1967. * * *

In arriving at this amount, the Commissioner assigned to the stock of Nassau a selling price of $168,445.60, a value equal to ten times the taxable income of Nassau for the taxable year ended June 30, 1966.[2] He then made the following computation:

Amount received in 1966 and 1967	$1,480,000.00
Less interest as reported	56,904.16
	$1,423,095.84
Amount deemed applicable to selling price of shares	168,445.60
Balance	$1,254,650.24
Less expenses incurred in 1967	63,098.07
Increase in ordinary income for 1967	$1,191,552.17
50% applicable to each shareholder	$ 595,776.09

2. Nassau's Federal income tax return for the year ended June 30, 1966, indicated taxable income of $15,831.56, which, multiplied by 10, equals only $158,315.60. The Commissioner, on brief, noted the discrepancy between this amount and the figure used in computing the deficiencies, but he does not now contend that the value of Nassau's stock should be limited to the lower figure.

OPINION

RAUM, *Judge*: This case presents a factual variation of a common transaction, the heart of which is the debt-financed acquisition of a going business by a tax-exempt organization. Prior to the Tax Reform Act of 1969, churches described in section 501(c)(3), I.R.C. 1954, which were exempt from ordinary taxation were also singled out in section 511(a)(2)(A) for relief from taxation on so-called unrelated business taxable income.[3] This provision enabled a qualified church to receive the income from the

3. Part III of Subchapter F of Chapter 1 of the Income Tax Subtitle of the Internal Revenue Code, consisting of sections 511 through 515, extends taxation to the business income of certain exempt organizations. The critical language therein is "unrelated business taxable income", a defined term denoting income from a trade or business carried on by the exempt organization but which trade or business is not substantially related to the organization's exempt purpose. Section 511(a)(1) contains the operative language of Part III, imposing a tax on the unrelated business taxable income "of every organization described in paragraph (2)". Section 511(a)(2), as effective in 1967, provided in relevant part:

> (2) Organizations subject to tax.—
>
> "(A) Organizations described in section 501(c)(2), (3), (5), (6), (14)(B) or (C), and (17), and section 401(a).—The taxes imposed by paragraph (1) shall apply in the case of any organization (*other than a church*, a convention or association of churches, or a trust described in subsection (b)) which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 401(a) or of paragraph (3), (5), (6), (14)(B) or (C), or (17) of section 501(c). Such taxes shall also apply in the case of a corporation described in section 501(c)(2) if the income is payable to an organization which, itself is subject to the taxes imposed by paragraph (1) or to a church or to a convention or association of churches." [Emphasis supplied.]

The Tax Reform Act of 1969, section 121(a)(1), repealed the preferred status of churches in respect of unrelated business income by deleting the parenthetical exception in section 511(a)(2)(A).

operation of a trade or business, itself unrelated to the church's exempt purpose, without incurring tax liability on the proceeds, provided the business was not conducted as a separate corporate entity.[4] Arrangements of this type held out to businessmen the prospect of relieving the tax burden on otherwise taxable business profits by "selling" the business to a church, which could then pass on a substantial portion of those untaxed profits to the seller as deferred payment of the purchase price, ultimately resulting in tax liability of the seller only for long-term capital gains.

In the case before us, the events of which transpired prior in time to the amendment of section 511(a)(2)(A), the Commissioner has challenged petitioners' decision to treat the payments received from Cathedral as long-term capital gains. He proposes two bases for this conclusion: first, that the totality of the dealings between the parties did not amount to a bona fide sale, without which long-term capital gain does not arise;[5] second, that in the event we find this transaction to exhibit the substance of a sale, the value of Nassau's stock was nevertheless limited to $168,445.60, and the payments which petitioners received in excess

4. Treas. Regs. section 1.511-2(a)(3)(ii).

5. SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle—

* * *

(3) Long-term capital gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * *

thereof were thus not "from the sale or exchange of a capital asset". To these contentions petitioners respond simply that there was a bona fide common law sale, that the agreed-upon price for Nassau's stock resulted from arm's-length negotiations between the parties and fell well within a reasonable range of values in light of Nassau's alleged potential sales volume. We, however, are not persuaded by the evidence before us that the Commissioner has erred.

It is a cardinal rule that, in characterizing a transaction for purposes of taxation, we are obliged to look beyond the form in which the parties have chosen to cast it and to draw our conclusions from that which we perceive to be the substance of the matter. *Griffiths* v. *Commissioner,* 308 U.S. 355, 357-358; *Higgins* v. *Smith,* 308 U.S. 473, 476; *Jack E. Golsen,* 54 T.C. 742, 754, affirmed 445 F. 2d 985 (C.A. 10). In particular here we must determine whether the parties effected a true sale of Nassau's stock. In its benchmark decision in this area, *Commissioner* v. *Brown,* 380 U.S. 563, the Supreme Court addressed itself to the relevant characteristics of a sale, stating (380 U.S. at 571):

> "A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent," *Iowa* v. *McFarland,* 110 U.S. 471, 478; it is a contract "to pass rights of property for money, —which the buyer pays or promises to pay to the seller * * *," *Williamson* v. *Berry,* 8 How. 495, 544.

Inherent in the Court's understanding of a sale is the notion of movement through exchange, the idea that, at the conclusion of the sale, the buyer possess that which

was the object of the sale. And, indeed, this comports well with the "common and ordinary meaning" of a sale. *Commissioner* v. *Brown, supra,* at 571. On the strength of this definition, the Supreme Court characterized the transaction before it as a sale, and in so doing it underscored a variety of detail which impresses us as highly significant in analyzing the facts before us.

At the outset, the Court recognized the necessity of construing the term "sale" in a manner consistent with the purpose of the capital gains provisions of the Code. That purpose is (380 U.S. at 572)—

> to afford capital gains treatment only in situations "typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130, 134.

Unlike the facts in *Brown,* in which the transferred business had an adjusted net worth of $619,457.63 which included $448,471.63 of accumulated earnings, at the time of the present transaction Nassau's balance sheet showed total assets of $53,867.56, accumulated earnings of $12,-348.62, and a net worth of only $12,548.62. Yet the purported sales price was a flexible figure between $500,000 and $3,500,000 as opposed to the correspondingly more realistic price of $1,300,000 in *Brown.* While the absence of accrued value is not conclusive with regard to the existence of a sale, it quite clearly demonstrates that the consideration here reflected whatever future income Nassau might produce rather than the typical capital gains situa-

tion "involving the realization of appreciation in value accrued over a substantial period of time" as was the case in *Brown.*[6] We think that such a transaction may most accurately be described as a retained proprietary interest by the shareholders in the business' future earnings rather than the creation of a creditor's interest in future earnings born of past accrued value of a capital asset. To treat such as a sale is at odds with the very purposes of the Code in allowing capital gains treatment for realization of the enhanced value of a capital asset.

The Court in *Brown* further stressed the express finding of the Tax Court that the price paid was within reasonable limits based on the earnings and net worth of the company. 380 U.S. at 572-574. In the context of a purchase to be financed entirely and exclusively from the earnings of the business acquired, this factor properly focuses attention upon what Justice Harlan referred to as the purchaser's "residual interest". *Commissioner* v. *Brown, supra,* at 581 (concurring opinion). While Justice Harlan agreed with the majority's conclusion that a sale had occurred, he offered the following analysis which we deem to be especially helpful in the case before us:

> [T]he Government might more profitably have broken the transaction into components and attempted to distinguish between the interest which [the taxpayers] retained and the interest which they exchanged. The worth of a business depends upon its ability to produce

6. In this respect, we regard the $3,000,000 range within which the purchase price was allowed to vary as incompatible with a sale of Nassau's past accrued value and goodwill. Rather, it is highly suggestive of an arrangement by which the Krauts retained a most substantial interest in Nassau's future profits.

> income over time. What [the taxpayers] gave up was not the entire business, but only their interest in the business' ability to produce income in excess of that which was necessary to pay them off under the terms of the transaction. The value of such a residual interest is a function of the risk element of the business and the amount of income it is capable of producing per year, and will necessarily be substantially less than the value of the total business. Had the Government argued that it was that interest which [the taxpayers] exchanged, and only to that extent should they have received capital gains treatment, we would perhaps have had a different case.

It follows therefrom that to the extent the so-called sales price is excessive, albeit agreed upon, the purchaser's residual interest is correspondingly diminished. Despite inadequacies in the record before us, there is sufficient evidence to create serious doubt in our minds that Nassau's expected earnings even approximated, no less exceeded, the level necessary to render payments to the Krauts of $3,500,000. And to the extent the clouded record precludes us from making any specific finding with reasonable confidence in this respect, we find that petitioners have failed to sustain their burden of proving that the facts were otherwise.

In urging upon us the reasonableness of the contract price, petitioners have relied heavily upon Aaron Kraut's projection of Nassau's earnings from its new Christmas wire, which valuation is supported, they argue, by the fact that Wilson Mold & Die Corporation, an allegedly nonexempt corporation subject to the constraints of taxation, agreed to substantially the same terms as did Cathedral

in a contract to purchase Nassau. At trial, Aaron Kraut testified that, based upon the customer acceptance of Nassau's new wire and the growing backlog of unfilled orders in the first half of 1966, he expected Nassau to yield gross profits of $10,000,000 during the ensuing ten years. We, however, simply do not believe this evidence. Petitioners introduced neither documentary nor other specific evidence of Nassau's allegedly skyrocketing business of early 1966. And Aaron Kraut's narrowly selective and seemingly self-serving memory rendered his testimony wholly unsatisfactory. On the one hand, he repeatedly professed his complete ignorance even of Trio's and Nassau's most general financial concerns, such as the information in tax returns which he himself had signed, explaining that his brother Harry handled all financial matters while he was engaged exclusively in the production end of the business.[7] Yet, with respect to the central question of the case, Nassau's

7. Another instance of Aaron Kraut's remarkably inconsistent memory arose in respect of the sale of Christmas Wire, an event no more than eight years past at the time of trial. He at first professed to have no recollection whatever of the purchase price, but after persistent questioning by the Court, prompted by the witness' startling total lapse of recall, he finally testified that the price was somewhere between $100,000 and $1,000,000. We did not find him a credible witness and are unwilling to ground our findings on what is so obviously contrived testimony.

We also mention that, although the Government had subpoenaed Harry Kraut to appear at trial, the Government's attorney explained that he had not sought to enforce the subpoena. Inasmuch as it was represented that Harry was scheduled to appear at a trial elsewhere at the same time, the Government attorney relied upon petitioners' counsel's assurance that Aaron was every bit as knowledgeable as Harry with respect to the details of Nassau's business. At trial, petitioners' counsel did not contest the accuracy of such representation, and we simply note that petitioners must bear the consequences of their failure to adduce credible evidence of Nassau's value.

earning capacity over a period of ten years, he presumed to ask the Court to rest content entirely on the strength of his knowledge of that matter. The valuation of a business is a delicate and sophisticated calculation, the more so with only one year's operation from which to extrapolate, and we are hardly inclined to credit Aaron Kraut with the necessary knowledge or ability to lend the slightest probative value to his testimony.

Insofar as Wilson is concerned, we are faced with unexplained silence. The record is barren of evidence with respect to Wilson. We do not know what business, if any, it conducted, who its principals were and what relationship, if any, existed between them and Cathedral or other persons involved in these transactions, and what negotiations, if any, preceded the signing of the contract. All we do know is that a party referred to as Wilson Mold & Die Corporation signed a contract to purchase Nassau's stock and 15 days later assigned the entirety of its interest in the contract to Cathedral. In the absence of any explanatory evidence (which was peculiarly within the control of petitioners) and in view of the two contracts' all too convenient timing, it is strongly suggestive the initial Wilson contract was merely a bootstrap effort to bolster petitioners' contention as to Nassau's fair market value, and we consequently must discount its evidentiary value.

In addition to petitioners' failure to produce credible evidence supporting the value they have tried to attach to Nassau, what evidence the record does provide in respect of this issue compels us to conclude that petitioners have failed to show that the contract price of as much as $3,500,000 was

not grossly excessive. Nassau was a company which, in its one year of existence, had managed to generate profits of less than $16,000 before taxes, with total assets amounting to slightly more than $50,000 and a net worth of $12,548.62. Its only fixed asset was an automobile. Its sole product was still experimental in June of 1966, untested in actual use over a period of time. Most significantly, though, was the fact that the Krauts neither obtained, nor apparently did they apply for, a patent on the new wire of such allegedly explosive sales potential, nor was it shown that production depended on a trade secret. Petitioners offered no explanation for such omission. Even assuming, arguendo, that this wire possessed the marketing potential urged by petitioners, without the protection afforded by a patent (and without any convincing evidence showing that production of the wire was based on a secret process) Nassau's competitors could have appropriated such a valuable process and a corresponding share of the market for such wire.

The decision in *Brown* rested as well upon a finding that the transaction had effected a real change of economic benefit, that the tax-exempt organization involved there was motivated by the genuine prospect of owning outright the substantial assets of a business after paying the purchase price in full. The record does not support a similar conclusion in the instant case.

Cathedral had no prospect of ending up with the substantial assets of an active business simply because Nassau owned no manufacturing assets at the time of the purported sale. Nassau's only fixed asset was an automobile; it owned no manufacturing equipment, no building, no inventory. The single piece of machinery employed in pro-

duction was the extruder which it leased from Trio. By the terms of that lease, Trio had the right to determine the nature or extent of use of the machine and Nassau could make no additions or alterations to the extruder without the permission of Trio. After the initial five year period ending on May 31, 1971, either party could unilaterally cancel the lease. In effect, the Kraut brothers, through their wholly-owned corporation, Trio, had reserved the power to terminate the lease and to repossess Nassau's sole source of income at any time after May 31, 1971. In that event, there would have been small likelihood that Nassau's two key employees, Aaron and Harry Kraut, would have remained with Nassau and applied their skills to rebuilding the business around a new extruder, even if one were available.[8] Reduced to its essentials, this arrangement in substance would have permitted petitioners, after five years, to deprive Cathedral of its newly acquired business, the value of which would have been obvious had the enterprise been sufficiently profitable to permit Cathedral to pay the Krauts in full.

On the other hand, although in *Brown* the Supreme Court rejected the argument that risk-shifting was an essential element of a bona fide sale, the transaction there nevertheless contemplated the payment by the exempt organization of a fixed price that we deemed to have a reasonable relationship to the subject matter of the sale. In the present case, however, the wholly unrealistic sales price coupled

8. The extruder here under discussion had been specially tooled for the production of this wire, and the record leaves in doubt whether an extruder adapted as such might be readily available for purchase or rental.

with the so-called sellers' remedy in the event of Cathedral's default makes it obvious that what we have here is a transaction designed, on the one hand, to insure Cathedral against any expense in the event Nassau failed to generate sufficient sales and, on the other hand, to provide the Krauts with the practical opportunity of recapturing the substance of Nassau's business in the event it proved profitable beyond the unrealistic level fixed in the contract. Our difficulty in discerning a sale in this arrangement is not that risk-shifting is absent; it is that nothing of substance has shifted other than a portion of the business' profits to Cathedral for a limited period of time. And the latter was merely the price that the Krauts paid for the opportunity of claiming capital gains treatment in respect of future speculative profits that might be realized by the enterprise. Petitioners have thus failed entirely to demonstrate that their arrangement with Cathedral contemplated the prospect of Cathedral retaining any residual interest in Nassau. It follows therefrom that the transaction lacked the essentials of an exchange upon the basis of which a sale might be founded.

In a recent decision of this Court, *Louis Berenson,* 59 T.C. 412, appeal pending (C.A. 2), the majority refused to recognize the bona fides of a purported sale of a business to a tax-exempt organization. In distinguishing the holding in *Brown,* the Court found that the agreed upon price was "grossly excessive", bearing no relationship to the value of the assets sold or to the earnings history of the business. The Court concluded therefrom that the sale was merely a sham. In the present case the facts are even stronger than those relied upon in *Berenson.* Not only have petitioners

here failed to demonstrate that the agreed upon price was not grossly excessive, but moreover they have not shown by satisfying evidence that Cathedral entertained even a remote prospect of actually acquiring anything of value. Cathedral's residual interest in Nassau was purely nominal, and we think the facts therefore fall within the rule of *Kolkey* v. *Commissioner*, 254 F. 2d 51 (C.A. 7), affirming 27 T.C. 37. The Seventh Circuit there decided that when, in a debt-financed acquisition by an exempt organization, the sales price is so grossly inflated that the purchaser's prospect of finally owning the business outright is at best remote, the transaction does not amount to a sale. Likewise in the instant case, we are not persuaded that petitioners formulated the terms of payment for any purpose other than to secure this right to receive 75 percent of Nassau's profits throughout the specified period. It is our opinion that the transaction never contemplated the actual transfer to Cathedral of a going business in fact. Far from comprising a sale, this was quite plainly an agreement to pay Cathedral a fee in return for lending its exemption to Nassau's earnings. This is not to say that every debt-financed acquisition of a business by a charitable organization which is payable exclusively from its future earnings is a tainted sale. But the sweep of *Commissioner* v. *Brown*, 380 U.S. 563, is not unlimited, and we do not believe that either the logic or the intent of the Court's decision there compels a finding for the petitioners before us. The Supreme Court itself in *Brown* recognized the appropriateness of a contrary result in cases like *Kolkey*, 380 U.S. at 574, n. 7, and, in our view, there was here similarly lacking a bona fide sale.

Although our finding that petitioners have failed to prove the existence of a bona fide sale to Cathedral is conceptually sufficient to render the entire net proceeds of the transaction taxable as ordinary income to Iris and Marian Kraut, the decisions to be entered herein will necessarily be limited by the Commissioner's computation in the deficiency notices. The Commissioner there determined an amount, $168,445.60, applicable to the selling price of the stock of Nassau (on the theory that there was a bona fide sale only to the extent of that amount), and only the proceeds in excess thereof, after deducting collection expenses of $63,098.07, and interest of $56,904.16, were deemed to be ordinary income to each of the shareholders. In the proceedings in this Court, the Commissioner contended alternatively that the entire transaction was lacking in bona fides—a conclusion which we have found to be valid and which would justify charging petitioners with the entire net proceeds undiminished by any so-called true selling price of $168,445.60.[9] However, the Commissioner has not sought to

9. As noted above, pp. 426-427, the Commissioner attempted to fix a selling price in terms of 10 times indicated taxable income. But, as pointed out in fn. 2, *supra*, such taxable income was $15,831.56, and 10 times that amount would be $158,315.60. Moreover, the usual method of computing value in terms of a multiple of earnings is to use an *after-tax* earnings figure, and if Nassau's $3,482.94 tax liability is subtracted from $15,831.56, there would remain net earnings of only $12,348.62. Accordingly, the 10 times earnings formula would yield a value of $123,486.20. It seems hardly likely that any greater multiple than 10 would be justified in the light of the fact that the stock was closely held, that the company's net assets were very modest in amount, that its only physical asset of any consequence was a second hand automobile, that its successful operation obviously depended upon the continued management of the enterprise by the Krauts, that it had such a brief history, and that its sole product was untested over a sufficiently lengthy period.

amend the pleadings to ask for increased deficiencies, and in the circumstances the redetermination of deficiencies herein will be limited accordingly. Section 6214(a); Tax Court Rule 41(a) and (b). Cf. *Commissioner* v. *Long's Estate,* 304 F. 2d 136, 141-142 (C.A. 9), affirming an unreported Tax Court Opinion. We wish to add that in neither *Commissioner* v. *Brown,* 380 U.S. 563, nor in *Louis Berenson,* 59 T.C. 412, did the respective courts have before them an allocation by the Commissioner to the purchase prices therein, and our conclusion in these proceedings that the entire transaction lacked bona fides should not be interpreted as being inconsistent with the propriety of making an allocation if the facts in a particular case are thought to justify such action.

Due to concessions in another respect made prior to trial,

Decisions will be entered under Rule 155.

APPENDIX II

Opinion of Second Circuit

Appendix II, Opinion of Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 359-360—September Term, 1975.

(Argued December 1, 1975 Decided December 31, 1975.)

Docket Nos. 75-4124, 75-4125

AARON KRAUT and IRIS KRAUT,
HARRY KRAUT and MARIAN KRAUT,
Petitioners-Appellants,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Before:

LUMBARD, FRIENDLY and MULLIGAN,
Circuit Judges.

Appeal from a decision of the United States Tax Court, Arnold Raum, *J.*, finding petitioners liable for income tax deficiencies arising out of the sale of stock to a tax-exempt organization.

Affirmed.

HERMANN ROGGE, New York, New York (O. John Rogge, New York, New York; Sidney N. Solomon, Lake Success, New York), *for Petitioners-Appellants.*

MICHAEL L. PAUP, Attorney, Tax Division, Department of Justice, Washington, D.C. (Scott P. Crampton, Assistant Attorney General, Gilbert E. Andrews, Jeffrey S. Blum, Attorneys, Tax Division, Department of Justice, Washington, D.C.), *for Respondent-Appellee.*

MULLIGAN, *Circuit Judge:*

These appeals by taxpayers raise once again the question of the tax consequences under §1222 (3)[1] of the Internal Revenue Code of 1954 of a sale of stock by an ordinary seller to a tax-exempt purchaser, when the sale is financed by the profits of the sold business. See *CIR* v. *Brown,* 380 U.S. 563 (1965) (*Clay Brown*). The transactions involved here preceded the Tax Reform Act of 1969[2] and the decision below was rendered before the opinion of this court in *Berenson* v. *CIR,* 507 F.2d 262 (1974). The question posed is to what extent, if any, are the proceeds of such sale to be considered ordinary income to the seller.

The taxpayers, Aaron and Iris Kraut, and Harry and Marian Kraut, appeal from decisions of the United States Tax Court which, in an opinion and findings of fact by Hon. Arnold Raum, filed on June 27, 1974 and reported at 62 T.C. 420 (1974), determined that Aaron and Iris Kraut

1. "For purposes of this subtitle— . . .

(3) *Long-term capital gain.*—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income."

2. That act, Pub. L. 91-172, 83 Stat. 536, repealed the preferred status of churches with respect to unrelated business income by deleting the former exception for churches in Int. Rev. Code §511(a)(2)(A).

owed a deficiency of $240,787.08 in income taxes for the year 1967 and that Harry and Marian Kraut owed a deficiency of $246,847.44 in income taxes for the same year.

I

Aaron and Harry Kraut had been for some twenty years in the business of manufacturing electric wire. The Krauts' business was operated through a variety of corporations, Trio Wire and Cable Corporation (Trio), Christmas Wire Manufacturing Corporation (Christmas), and eventually in 1965 Nassau Plastic and Wire Corporation (Nassau). Iris Kraut and Marian Kraut each contributed $100 to Nassau in exchange for 100 shares of stock in the corporation. Their husbands were not stockholders but effectively operated the business. Nassau occupied a leased building, previously occupied by Christmas, on Meserole Avenue in Brooklyn, where it kept its only equipment, an extruder owned by Trio. The extruder was utilized to manufacture Christmas wire which is light gauged and protected by a plastic insulation. Christmas decoration manufacturers purchased the wire and attached to it light bulb sockets which puncture the plastic jacket and make contact with the wires. Nassau had developed a new insulating material which was easily penetrable and was likely to minimize manufacturer rejection which had plagued the Christmas-light business in the past.

In 1966, an investment counseling firm brought a proposal to Rev. Rex T. Humbard, pastor of the Cathedral of Tomorrow (Cathedral), a tax-exempt religious corporation in Akron, Ohio, that it purchase Nassau. Before any

deal was consummated, however, the Krauts entered into a contract of sale on May 31, 1966 with Wilson Mold & Die Corporation (Wilson) which purported to sell all the stock of Nassau to Wilson. Shortly thereafter, on June 15, 1966 the Krauts entered into a three-cornered deal with Wilson and Cathedral whereby Wilson was relieved of its obligation to buy the Nassau stock and Wilson assigned all of its rights and obligations to Cathedral. The significant terms of the agreement are set forth in the margin.[3] We

3. "The Buyer [Cathedral] shall take all such action as may be required so that on or as of June 25, 1966 Nassau Plastic shall be liquidated and all of its assets distributed to the Buyer. Simultaneously with the execution of this Agreement, the Buyer, with the consent of the stockholders and directors of the Sellers [Iris and Marian Kraut], shall take steps forthwith to accomplish the following:

(a) Create a separate operating-manufacturing unit, owned by the Buyer, to be denominated and known as Nassau Plastic (hereinafter sometimes interchangeably referred to as 'Nassau Plastic & Wire Co.' * * *); the Buyer to file such documents with the proper governmental authorities as may be necessary to effectuate the same.

(b) The name of Nassau Plastic & Wire Corp. shall be changed forthwith, to such name as the Buyer may designate.

* * *

The purchase price for all of the stock sold under this Agreement shall be not less than $500,000 (hereinafter called the 'Minimum Price') nor more than $3½ million (hereinafter called the 'Maximum Price'). The purchase price shall be paid by the Purchaser to the Sellers at the following time in the following manner and to the extent set forth below:

(a) For the period from June 25, 1966 to July 1, 1966, 100% of the net income of the Corporation shall belong to the Sellers; the Purchasers shall receive credit for said amount toward the purchase price.

(b) $50,000 on or before August 1, 1966.

(c) For the balance of the year 1966 and in each of the years 1967 through 1976 terminating however on June 30, 1976 inclu-

(footnote continued on next page)

note that the sales price was dependent upon Nassau's future profits and was to range from a minimum of $500,000 to a maximum of $3,500,000, entirely paid from the sold business's income, for the following ten years. The Krauts, husbands of the Nassau stockholders, were retained as employees of Cathedral at $5,200 each per annum and so remained in effective day-to-day control of the business. Cathedral qualified under §501(c)(3) of the Internal Revenue Code as a tax-exempt religious organization and so was exempt from paying either normal income taxes or taxes on unrelated business income.[4] Cathedral paid off its debt to the Krauts with tax-free income from Nassau.

The agreement further provided that the taxpayers were to retain a security interest in all of the assets of Nassau subordinate to prior liens and the right of present

sive, unless the Maximum Price be paid in full prior thereto; commencing with the 15th day of October 1966 and on the 15th day of each January, April, July and October thereafter in respect to each preceding quarterly period from July 1, 1966 through June 30, 1976, an amount equal to 75% of the Corporations [sic] net income before Federal income taxes for each of such next preceding fiscal periods. In the event a loss occurs in any quarterly period, said loss shall be utilized as an offset in each of the succeeding quarterly periods (until said loss has been recouped) before payments to the Sellers are resumed.

(d) In any event and notwithstanding any provision in this Agreement with respect to the contingent deferral of installment payments of the Purchase Price, the full Minimum Price referred to above and any portion of the Maximum Price referred to above which Sellers may become entitled to receive shall be paid in full on or before July 15, 1976.

(e) The Purchaser may prepay at any time all or any part of the unpaid amount of the Maximum Price."

4. However, the Tax Reform Act of 1969 later changed the status of churches as regards unrelated business income. See note 2 *supra* and accompanying text.

and future creditors. In the event of default by Cathedral, enforcement of the security agreement constituted the taxpayer-sellers' exclusive remedy with no right to secure any deficiency judgment or other judgment for damages against Cathedral.

The business was initially very successful. Cathedral paid Iris and Marian Kraut $147,500 in 1966 (including a required $50,000 down payment) and $1,332,500 in 1967. Thereafter the business became unprofitable and ceased operation in 1969. The taxpayers, after deductions, each reported $606,416.67 as long-term capital gains for 1967. The Commissioner determined that $595,776.09 of each couple's receipts was taxable as ordinary income. He deducted the value of Nassau's stock from the taxpayers' receipts under the sales contracts, assigning a value of $168,445.60 to the stock, an amount equal to ten times Nassau's taxable income for the year ended June 30, 1966, the year prior to the sale. Taxpayers then filed petitions contesting the determination, taking the position that the property sold was a capital asset so that the gain was taxable only as a long-term capital gain. The Tax Court rejected this contention and this appeal followed.

II

In *Clay Brown* the Supreme Court held that the somewhat similar transaction there involved constituted a sale within the meaning of §1222(3) (and thus was taxable as long-term capital gain) even though the exempt organization incurred no downside risk. The absence of a shift in risk did not preclude the "sale" of the stock and underlying assets under applicable law. The Court further noted the Tax Court's finding that the purchase price was "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets." 380 U.S. at 572. In *Clay Brown* the appraised net worth of the assets of the business was $1,064,877 and the sales price was approximately $1,300,000.

This court faced a related problem in *Berenson,* which involved a bootstrap sale of closely held corporate stock. There a tax-exempt entity agreed to pay $6,000,000 over a twelve-year period for stock, a price which the Tax Court held was more than double the price that would be paid for the same stock by a prospective purchaser who was not exempt from income tax. We held that *Clay Brown* did not wholly govern in view of the disparity in *Berenson* between the prices that exempt and non-exempt purchasers would pay, a disparity that did not exist in *Clay Brown.* Rather than holding that none of the proceeds were entitled to capital gains treatment, since a sale had in fact occurred in *Berenson* within the *Clay Brown* rationale, we determined:

> In sum, we conclude that the portion of the purchase price agreed to by Temple [the tax-exempt entity] and Taxpayers that is in excess of the price a non-exempt purchaser would have paid under identical terms is not part of the proceeds of a §1222(3) "sale," and is, therefore, taxable as ordinary income to the recipients.

507 F.2d at 269.

Both parties to this appeal agree that *Clay Brown* and *Berenson* are applicable. The appellants maintain however that the fair market value of the stock of Nassau should

be held to be $3,500,000, which was the maximum price that the non-exempt purchaser Wilson as well as Cathedral agreed to pay. The appellee argues that the allocation made below should be affirmed on the basis of our holding in *Berenson.*

In light of *Berenson* we feel constrained to find that the sale was bona fide under *Clay Brown* and the Commissioner on this appeal does not argue to the contrary. The Tax Court below, which rendered its decision before *Berenson* was decided, concluded that the sale was not bona fide within *Clay Brown* and would have charged the taxpayers with the entire net proceeds undiminished by any so-called "true selling price." However, the Commissioner had previously determined an amount of $168,445.60 to be a bona fide sales price and had limited the taxpayers' ordinary income tax liability to the excess over that true value. Since the Commissioner had not successfully sought to amend the pleadings below to ask for increased deficiencies,[5] the Tax Court felt compelled to make the allocation set by the Commissioner. Thus, although Judge Raum found that no bona fide sale took place, he applied in effect the *Berenson* allocation rule yet to be articulated by this court.

III

The sole issue before us is whether or not the Tax Court's refusal to disturb the Commissioner's determination that the true value of Nassau's stock was $168,445.60

5. After the opinion below was filed, the Commissioner, no doubt prompted by the opinion's finding that no bona fide sale existed, moved to amend its answers to so allege. The motions were summarily denied by Judge Raum on July 26, 1974.

was erroneous. We commence with the proposition that the deficiency asserted by Commissioner is presumptively correct and the burden of disproving it rests upon the taxpayer. Rule 142(a), Rules of Practice and Procedure of the United States Tax Court (see 26 U.S.C.A. §7453 (1975 Supp.)); *Helvering* v. *Taylor,* 293 U.S. 507, 515 (1935) ("Unquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid" (citations omitted)); *Rockwell* v. *CIR,* 512 F.2d 882, 885 (9th Cir. 1975); *Valetti* v. *CIR,* 260 F.2d 185, 187 (3d Cir. 1958) ("It is the burden of a taxpayer who institutes such a suit as this to overcome the presumption that the Commissioner's deficiency finding was correct by showing by a preponderance of evidence that the Commissioner erred."); 10 J. Mertens, Federal Income Taxation §55.18, at 113-14 and cases cited (1970).

The taxpayers rely upon *McSpadden* v. *CIR,* 50 T.C. 478, 491-94 (1968) and *Wilson* v. *CIR,* 25 T.C. 1058, 1066 (1956) for the proposition that when the Commissioner departs from the grounds relied on in his deficiency notice to sustain a theory later raised, he has the burden of proving any new matter. While the Commissioner here did contend below that the entire transaction lacked bona fides and the Tax Court agreed, which would have resulted in the application of ordinary income tax liability for the entire proceeds of the sale, Judge Raum expressly limited the Commissioner to its previous deficiency notice. Hence we have no occasion to decide whether the Commissioner carried any burden of establishing that no bona fide sale at all took place. The burden of establishing what was a fair market value therefore remained with the taxpayer.

As we indicated in *Berenson,* the test to be applied in determining the extent of capital gains treatment is the establishment of the fair price which a non-exempt entity would pay for the stock in an arm's length negotiation. Here the taxpayers had the unique advantage of being able to show that Wilson, just 15 days before Cathedral received its assignment, was willing to pay the same price on practically identical terms.[6] But not only was there no evidence of the Wilson-Kraut negotiations, the record is also barren of any proof that Wilson even exists or if it does, that it is a non-tax-exempt entity. The agreement assigning Wilson's contract of sale to Cathedral not only fails to provide any financial consideration for the assignment by Wilson but it is not even signed by any Wilson representative. (The original contract between Nassau and Wilson is signed by one Leon Lautin on the latter's behalf but no corporate title is indicated.) Judge Raum noted below: "In the absence of any explanatory evidence (which was peculiarly within the control of petitioners) and in view of the two contracts' all too convenient timing, it is strongly suggestive [sic] the initial Wilson contract was merely a bootstrap effort to bolster petitioners' contention as to Nassau's fair market value, and we consequently must discount its evidentiary value." 62 T.C. at 431.

The only evidence presented by the petitioners below as to Nassau's fair market value was the testimony of Aaron Kraut, who testified that, on the basis of consumer ac-

6. The only difference was that Wilson had agreed to pay the taxpayers 75% of its pre-tax earnings for five yars and thereafter 75% of its after-tax earnings, while Cathedral had agreed to pay 75% of its pre-tax income for the entire ten-year period.

ceptance of Nassau's new wire and unfilled orders for the first half of 1966, he anticipated gross profits of more than $10,000,000 during the next ten years. No documentary evidence of any sort was submitted in support of this estimate. Moreover, Judge Raum held "we . . . simply do not believe this evidence." He characterized Kraut's memory of the transaction as "narrowly selective and seemingly self-serving . . . we are hardly inclined to credit Aaron Kraut with the necessary knowledge or ability to lend the slightest probative value to his testimony." 62 T.C. at 430-31.[7] In view of Judge Raum's opportunity to observe the demeanor of the witness we obviously cannot characterize this finding of fact as clearly erroneous. *CIR* v. *Duberstein,* 363 U.S. 278, 291 (1960); *Adler* v. *CIR,* 422 F.2d 63, 68 (6th Cir. 1970) (credibility of witnesses is particularly for the Tax Court); *Casey* v. *CIR,* 267 F.2d 26, 31 (2d Cir. 1959) (same) (dictum). Finally, the fact that a tax-exempt organization was willing to pay a maximum price of $3,500,000 for the stock was obviously not probative of its value to a non-tax-exempt entity.

On appeal, the taxpayers urge that Judge Raum did not sufficiently recognize that Nassau had a "valuable trade

7. In addition, Judge Raum noted that another Kraut, Aaron's brother Harry, was actually the witness the government had subpoenaed to appear at the trial. The government did not attempt to enforce its subpoena in part because petitioners represented that Aaron was as knowledgeable as Harry as regards the details of Nassau's business. However, on the stand Aaron at times professed ignorance of Nassau's financial concerns, explaining that Harry and not he himself handled all financial matters for the company. 62 T.C. at 430. Judge Raum concluded this point by saying, ". . . we simply note that petitioners must bear the consequences of their failure to adduce credible evidence of Nassau's value." Id. at 431 n.7.

secret for the production of a dramatically new type of Christmas tree lighting wire." On the contrary, Judge Raum found that there was no convincing evidence that the production of the wire was based on a secret process and further noted that Nassau had no patent protection for its "secret". Nassau's competitors were free to appropriate the process and Nassau's short-lived success would tend to support the argument that this eventually happened by 1968. It is also significant that Kraut testified that the new plastic material was an "unknown quantity" and that after discussions with his accountant and attorney decided "we would be complete idiots to take a chance on putting—producing this material in Trio Wire and jeopardizing the corporation."

The other evidence of value is supportive of the view that the Commissioner's valuation of $168,445.60 for the Nassau stock is not clearly erroneous.[8] In the one-year period of its existence prior to sale, it had a taxable income of less than $16,000; its total assets were slightly in excess of $50,000, most of which consisted of accounts receivable. Its only owned asset was a used automobile. It leased the building in which it operated and the only equipment utilized in manufacturing the Christmas decoration wiring, the extruder, was leased from Trio at $500

8. We note that, in general, a trial court's evaluation of stock or other property is subject to reversal only if it is clearly erroneous. E.g., *Bormes* v. *CIR*, 512 F.2d 442 (8th Cir. 1975) (*per curiam*) (affirming valuation of real estate donated to charity, where Tax Court sustained the Commissioner's valuation); *Rubber Research, Inc.* v. *CIR*, 422 F.2d 1402, 1405 (8th Cir. 1970) (per Blackmun, *J.*) (valuation of stock for tax purposes is a question of fact, and hence is subject to the "clearly erroneous" standard of review); *Seas Shipping Co.* v. *CIR*, 371 F.2d 528, 532 (2d Cir.), cert. denied, 387 U.S. 943 (1967) (same).

a month. Although Nassau's earnings rose rapidly after the sale to Cathedral, and the Krauts received $1.48 million under the contract, the company suffered a precipitous drop in income that could not have been wholly unexpected given the failure to attempt to patent the "unique" process. By 1969, Nassau had ceased all operations.

It is true that the Tax Court made no specific finding that the true value of Nassau was $168,445.60 since it found that the sale was not bona fide. However, it did accept the deficiency assessment of the Commissioner and the taxpayer failed miserably to shoulder the burden of establishing that this was erroneous. A casual reading of its opinion indicates that the Tax Court, had it anticipated *Berenson's* requirement of an apportionment, would have found Nassau's value to be, if anything, less than that determined by the Commissioner. The Commissioner's evaluation was based upon a formula of ten times Nassau's taxable income for the fiscal year ending on June 30, 1966. Judge Raum pointed out, however, that this would result in a price of $158,315.60 since Nassau's taxable income for 1966 was only $15,831.56. He further noted that the usual method of computing value in terms of a multiple is to employ an *after* tax earnings figure which would yield a value of $123,486.20. He explicitly noted that a greater multiple than ten would not be justified since the stock was closely held, the company's net assets were modest, its history brief and its sole product was untested over a sufficiently lengthy period. While the Commissioner's findings on valuation were far less specific than those presented in *Berenson*, where an expert witness testified as to a detailed formula for estimat-

ing the price that would be paid by a non-exempt purchaser, those findings must stand in light of appellant's failure to present any countervailing evidence. We see no advantage in remanding for a specific finding of value by the Tax Court since it could not be any greater than that found; if less, both the Tax Court and this court would be bound by the Commissioner's initial determination. In any event, neither party has sought such a remand.

Finally, taxpayers argue that the fair market value of the Nassau stock could not be less than forty-eight percent of the price which Cathedral agreed to pay since in 1967 the corporate tax rate was forty-eight percent on profits in excess of $25,000. We fail to see any nexus between a non-exempt entity's tax bracket and the price a tax-exempt entity might be willing to pay. There is no such limitation in *Berenson* and no authority is cited for the proposition.

We affirm.

APPENDIX III

Order Denying Rehearing

Order Denying Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 15th day of January, one thousand nine hundred and seventy-six.

Present:

HON. J. EDWARD LUMBARD,
HON. HENRY J. FRIENDLY,
HON. WILLIAM H. MULLIGAN,
Circuit Judges.

Docket Nos. 75-4124-5

AARON KRAUT and IRIS KRAUT,
HARRY KRAUT and MARIAN KRAUT,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

A petition for a rehearing having been filed herein by counsel for the appellants,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

/s/ A. DANIEL FUSARO
A. DANIEL FUSARO
Clerk